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IN THE

Supreme Court of the United States

No. 78-1694

C. DOUGLAS WILSON & COMPANY
A South Carolina Corporation,

Petitioner,

versus

INSURANCE COMPANY OF NORTH AMERICA, Philadelphia, Pennsylvania; HARTFORD ACCIDENT AND INDEMNITY COMPANY, Hartford, Connecticut; and ST. PAUL FIRE AND MARINE INSURANCE COMPANY, St. Paul, Minnesota,

Respondents.

BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI

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STATEMENT OF THE CASE

Both the Insurance Company of North America (hereinafter INA) and the Hartford Accident and Indemnity Company (hereinafter Hartford) bonds involved in this matter are blanket bonds. They are designed tc provide a corporate insured with fidelity coverage for all of its employees. No notice is required by the insured to the surety as employees come and go in employ. The very nature of the bond presupposes that the insured will not hire or allow to remain in employ any known dishcnest employee. The bonds contain contract provisions which terminate coverage as to a dishonest

employee upon the discovery of the dishonesty, whether loss results or not.

The defense of INA and Hartford does not turn on notice of loss following the discovery of loss, which is a different situation altogether. Rather, INA and Hartford defended by establishing that C. Douglas Wilson & Co. (hereinafter CDW) knew before the inception of coverage by INA and Hartford that the employee whose conduct caused a loss was dishonest and that this knowledge, uncommunicated to the sureties, precluded there being any coverage for this individual.[1] The bonds, however, covered all other employees of the insured corporations for a variety of risks to the corporations.

CDW became a named insured under the INA and Hartford bonds effective March 25, 1973. During the trial of the case the testimony and evidence established, and petitioner does not contend otherwise, that there was no coverage by INA or Hartford prior to March 25, 1973. This then became the crucial date.

On March 16, 1973, Robert Shaw, a credit review officer for NCNB Corporation, visited CDW for a credit review, during which he was to inspect the commercial loan files. He had in the past conducted just such a credit review of NCNB Mortgage Corporation which was involved in the same type of loans. He was to report his findings to the President of NCNB Mortgage, the President of CDW and directly to the Chairman of the Board of NCNB Corporation.

[1]Under its bond INA insured NCNB Corporation and its subsidiary corporations, including, as of March 25, 1973, CDW; under its bond Hartford insured NCNB Corporation's mortgage banking subsidiaries, NCNB Mortgage Corporation and, as of March 25, 1973, CDW. Under the terms of the INA and Hartford bonds knowledge possessed or discovery made by any insured under the bond or by any partner or officer thereof constitutes knowledge possessed or discovery made by every insured under the bond.

On March 16, 1973, nine days before the inception of coverage of the bonds involved here, Shaw found that Barksdale, an employee of CDW, in several HUD insured loans was falsely certifying information on documents which were being furnished to HUD. More specifically, Shaw found that Barksdale had submitted written certification to HUD that certain construction advances had been made on dates and in amounts approved by HUD when in fact Barksdale knew that the advances had been made on dates and in amounts not approved by HUD and that the written certification submitted to HUD was, therefore, false. Shaw confronted Barksdale and ascertained that the facts were as they had appeared to Shaw to be.

The certificates were not merely trivial paperwork. They required that the date and amount of each construction advance be shown and certified to and the certificate in question was necessary in order for HUD to issue its final insurance policy. The form was a sworn confirmation to HUD that the construction advances had been properly handled. Without the HUD final insurance, the loan could not have been finally closed and could not have been marketed. Also, CDW was privileged to be an approved lender, and flagrant breaches of HUD regulations, if detected, would have jeopardized that relationship.

Shaw then prepared a handwritten memorandum at home on Sunday, March 18 and had this typed on March 19, 1973. He submitted it to Ridgeway, President of CDW, to Cashion, Chairman of the CDW Board and President of NCNB Mortgage, and to Reece, Chairman of the NCNB Corporation Board. Taylor, a senior Vice President of CDW and in overall charge of these HUD loans, was also given a copy on or about March 19, and before March 25, 1973. This report or memorandum was an exceptional occurrence, for Shaw's reports

normally came at the end of a review unless something noteworthy was found.

Thus, prior to March 25, the crucial date, the Chairman of the Board of NCNB, the Chairman of the Board of CDW (who was also President of NCNB Mortgage), the President of CDW, the senior Vice President of CDW in this area, and the credit review specialist for NCNB Corporation were all aware of an employee's purposeful furnishing of false information to an agency of the Federal Government. Special meetings had been held to discuss the situation. Each acknowledged knowing the name of the individual involved. Each of these men denied ever themselves intentionally furnishing any false information to anyone and acknowledged knowing that it would be wrong to do so.

Cashion, who had worked for years with the FHA and HUD, had seen and was familiar with the forms involved. Upon receipt of the memorandum, he verified with NCNB Mortgage personnel that they were not involved with any similar conduct. He was aware that the situation posed a threat of monetary loss to CDW. He was aware that the situation threatened the relationship of CDW with the FHA.

Cashion testified that although he thought the situation could be cleared up, the memorandum contained a description of dishonesty. He also agreed that to his mind's eye, on March 19, 1973, the memorandum was a report of apparent dishonest conduct.

Reece, Chairman of NCNB Corporation, testified that the policy of that company was to furnish truthful certifications to the Federal Government. He also agreed that even considering Barksdale's explanation for his actions, they were still not to be tolerated in Reece's organization. He acknowledged that the certifications were without question false and that he knew them to be so on March 19 or 20, 1973.

Petitioner does not contend that any contact or notice concerning the occurrence described above was made with or furnished to INA or Hartford prior to March 25, 1973. Cashion testified that he was aware on March 19, 1973 that these companies would be accepting the risk of bond coverage for CDW effective March 25, 1973.

REASONS FOR DENYING THE WRIT OF CERTIORARI

I.

The Decision of the Fourth Circuit Court of Appeals has not created a conflict with the decision of any other Court of Appeals.

Petitioner does not suggest that there is a conflict among the several Courts of Appeals.

II.

The Fourth Circuit Court of Appeals has not decided an important state question in a way in conflict with applicable state law.

Petitioner's argument that the Courts below violated the principles of *Erie R. Co. v. Tompkins*, 304 U.S. 64, 58 S.Ct. 817, 82 L.Ed. 1188 (1938), relies in the main on the South Carolina case of *Peurifoy v. Loyal*, 154 S.C. 267, 151 S.E. 579 (1930) as having applicability to the facts of this case. *Peurifoy* is factually inapposite. It did not involve a situation where the dishonesty of an employee was discovered before the inception of bond coverage. Rather, it involved two bonds which had covered the employees in question for a period of time before commission of the dishonest acts which led to the loss occurred.

Whether there was bond coverage as to the employees in question was not before the *Peurifoy* Court. The majority saw the surety's position as being ". . . that the bank had

forfeited its right to recover by not notifying the surety within 10 days after discovery of the alleged loss." 154 S.C. at 278, 151 S.E. at 583. The question was one of notice of loss where coverage definitely existed as opposed to the question which faced the Courts below in this case, which was whether there was any coverage at all as to Barksdale.

The case is also readily distinguishable because there was no provision in the *Peurifoy* bond, as there is in the bonds involved here, for the imputing of knowledge of uninvolved employees, officers or directors to the insured corporation. The imputation issue was the true focus of the majority opinion.

Factually, *Peurifoy* involved two bank directors, Matthews and Mauldin, who misappropriated two investment bonds which they had purchased for the bank's portfolio. They used them as security to obtain an appeal bond needed for an appeal in a personal tax matter.

Notice of what the directors had done came to three people. The notice or disclosure came first to two directors, Byrd and DuPre, at a finance committee meeting and subsequently to the cashier, Earle, who read the minutes of the meeting at a later time. The Court summarized the defendant's position as follows:

> It is claimed by the surety company: First, that the finance committee representing the board of directors, under the bylaws of the bank, had *discovered the loss* at the time the resolution prepared by Mr. Byrd was adopted; second, that the two directors, Byrd and DuPre, at the time the committee met, *discovered the loss*, and that their discovery was imputable to the bank; and, third, that Earle, the cashier, had *discovered the loss* and his discovery can be imputed to the bank.

Peurifoy, supra., 154 S.C. at 285, 151 S.E. at 585.

In the opinion it was noted that the bank had twenty-two directors. Of these, five composed the finance committee which was authorized to act for the board as a whole. The five were Byrd, DuPre and Miller, who were not involved in the bond scheme, and Matthews and Mauldin who were.

On the occasion of a meeting of the finance committee, Miller, who was not involved, was absent. A proper quorum would have been three directors. Miller's absence left Byrd and DuPre, who were not involved, and Matthews and Mauldin. At the end of the meeting, Matthews and Mauldin told the other two that bonds belonging to the bank had been used temporarily and that security would be put up if a loss occurred. The minutes of the meeting contained a resolution purporting to authorize the borrowing. It was these minutes that the cashier later read.

The surety's first argument was that the finance committee, acting for the Board of Directors, had discovered the loss at the time the resolution by Byrd was prepared. The Court held that the committee was not legally constituted, as the directors having adverse interests could not be counted in determining the quorum. This conclusion was reached based upon well settled principles of corporate law. As there was no quorum, the Court held that:

> . . . so far as any matter relative to the taking of the bonds was concerned, this was not a lawful meeting of the finance committee as would bind the bank, and there could be no discovery of a loss by it as a committee.

Peurifoy, supra., 154 S.C. at 286, 151 S.E. at 586.

Next was considered the surety's argument that the information known to Byrd and DuPre, the directors, and Earle, the cashier, should be imputed by way of agency theories to the bank. The Court refused to hold that it was

imputable and the opinion clearly shows that this was because there was no provision in the bond calling for knowledge of uninvolved fellow employees to be imputed. In reaching this decision the South Carolina Court quoted at length from this Court's opinion in *Fidelity & Deposit Company of Maryland v. Courtney*, 186 U.S. 342, 22 S.Ct. 833, 46 L.Ed. 1193 (1902). The quotation commenced with the conditioning language ". . . in the absence of express agreement", thereby distinguishing situations where a bond provides for imputation by way of express agreement from those where there is no such provision. *Peurifoy, supra*, 154 S.C. at 294, 151 S.E. at 588. If there could be any doubt about the truth of this observation, it would be dispelled by the fact that *Fidelity* concerned the ". . . imputing to the corporation of knowledge acquired by another employee subsequent to the execution of the bond" and further because in *Fidelity* this Court said that:

> "As the rule of imputation to the principle of the knowledge of an agent does not apply to such a case, it must follow that it can only obtain as a consequence of an express provision of the contract of suretyship."

Peurifoy, supra, 154 S.C. at 296, 151 S.E. at 589, *quoting from Fidelity, supra*, 186 U.S. at 362, 22 S.Ct. 833, 46 L.Ed. at 1202.

Still another reference to the distinction between bonds which contain provisions for imputation from those which do not appears in the South Carolina Court's quotation of an author, Morse, who himself quoted Chief Justice Shaw of Massachusetts, which quote in pertinent part said that imputation would not lie ". . . unless it is so expressed in the bond." *Peurifoy, supra*, 154 S.C. at 292, 151 S.E. at 587.

Because of the Court's several references to the absence of contract provisions requiring imputation, it seems fair to assume that the Court would have enforced them had they been present. In similar fashion, the fact that both in *Peurifoy* and the cases from other jurisdictions cited in *Peurifoy*, coverage had already attached to the employee in question prior to discovery of dishonesty highlights the distinction between *Peurifoy* and the present case.

In summary, the South Carolina Supreme Court was dealing in *Peurifoy* with a situation where coverage had gone into effect before discovery of either loss or dishonesty occurred. In particular, it was concerned with the date of discovery of loss rather than discovery of dishonesty. Judge Hoffman recognized this distinction in his dissenting opinion. (Appendix B, p. A-54). The South Carolina Supreme Court emphasized that *Peurifoy* involved discovery of loss by italicizing "discovery of loss" in three places in the paragraph which Judge Hoffman quoted in his dissent. Judge Hoffman quoted the paragraph as it had appeared in the opinion complete with the emphasis, (Appendix B, p. A-54), while the Petitioner chose to delete this emphasis (informing this Court that it had done so) (Petition, pp. 10-11). The distinction between a discovery of loss case where coverage had been in effect as to an employee and a case where dishonesty of an employee is discovered before coverage attaches cannot be over-emphasized. Finally, *Peurifoy*, was dealing with and the cases it cited dealt wth a suretyship contract which did not provide for imputation of knowledge.

Pertinent portions of *Peurifoy* have been cited in four subsequent cases. None involved factual situations similar to that before the Court. One involved a demurrer. *Farley v. American Surety Co. of New York*, 182 S.C. 187, 133 S.E. 776 (1936). The other three involved questions of corporate law relative to the extent of participation allowed by a self-interested or adversely interested director in a corporate transaction. *Fidelity Fire Insurance Co. v. Harby*, 196 S.C. 238, 193 S.E. 141 (1930); *Gilbert, et al v. McLeod Infirmary, et al*, 219 S.C. 174, 64 S.E. 2d 524 (1951); *Talbot v. James*, 299 S.C. 73, 190 S.E. 2d 799 (1972).

We submit therefore that there is no defined body of South Carolina law which has direct application to the

present case. We found no South Carolina Supreme Court case involving a modern day banker's blanket bond such as those before the Court. The good sense of a rule which prohibits an employer from bringing a dishonest employee beneath the umbrella of protection afforded by an unsuspecting surety's bond is self-evident.

Nor does *Buddin v. Nationwide Mutual Ins. Co.*, 250 332, 157 S.E. 2d 633 (1967), state any rule of substantive law which has been improperly applied by the Courts below. The holding of *Buddin* may be summarized in the words of the South Carolina Court, citing a North Carolina case:

> The Courts have uniformly held that where the clause [in question] is one of inclusion it should be broadly construed for the benefit of the insured while in exclusion cases the same clause is given a more restricted interpretation.

Buddin, supra, 250 S.C. at 337, 157 S.E. 2d at 635.

Even though the Buddin case involved an auto liability policy and the question of whether a nephew was a "relative resident of the same household", and is therefore without the slightest bit of factual similarity to the present case, it does state a general rule of law. However, the case clearly does not purport to state that the South Carolina Supreme Court would refuse to enforce an exclusionary clause in a proper case.

Petitioner would suggest that the failure of the District Court and the Court of Appeals to discuss the above cases in the opinions below indicates that the District Court and the Court of Appeals failed to consider the substantive law of the State of South Carolina. That these cases and the substantive law of South Carolina were considered is, however, made clear by CDW's own Petition; for, as CDW points out at pages 11 and 12 of its Petition, these cases were fully discussed by CDW both in its Brief and in its Petition for Rehearing before the Court of Appeals. (Presumably these

cases were also discussed by CDW in its Brief in the District Court.) We respectfully submit that these cases, fully and ably briefed by CDW, were duly considered by the Courts below, were found to be distinguishable, and were rejected as being of no authority in the present case.

III.

The Granting and Upholding of the Judgment Notwithstanding the Verdict by the Courts Below was Proper in this Case.

Petitioner appears to argue that the testimony of its highest officers to the effect that they did not appreciate dishonesty on the part of Barksdale, regardless of how that flies in the face of their other testimony and common sense reason, makes a jury issue of the question of whether there was knowledge of dishonesty prior to March 25. Had the courts below accepted this logic, the effect would have been to create a body of law which would reward the most unscrupulous insured imaginable who would without blinking an eye acknowledge an overwhelming array of facts showing knowledge of dishonesty and then brush them away by saying that to him the facts did not reveal dishonesty.[2] Such a man could obtain a bond on his dishonest employee from an unsuspecting surety, secure in the knowledge that if he stood fast as to his incredulous testimony, at least a jury issue would always be raised. We believe that the right to a jury trial was never meant to go so far.

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[2]Although CDW in its Petition refers to the District Court opinion as "confusing" (Petition, p. 6), the District Court opinion by the judge who sat throughout the trial of this case makes clear that the evidence of a dishonest act and the insured's knowledge of the same was so overwhelming as to be the only reasonable inference to be drawn from the evidence presented, thus making judgment as a matter of law appropriate. See, for example, Appendix A, page A-21, where Judge Chapman states "that the evidence is so overwhelming that it proves, as a matter of law, both that Barksdale's conduct in falsely certifying the Request for Final Endorsement was dishonest and that the management of CDW knew about this dishonesty prior to March 25."

The Order of Judge Chapman sets forth the two elements which defendants were obligated to establish in their defense.

> First they had to prove that some act of Barksdale, which was connected with the over advancing, constituted a dishonest act. Second, they had to prove that some officer or director of NCNB Corporation or CDW knew or had reason to know prior to March 25 that Barksdale had committed a dishonest act.

Appendix A, p. A-19. The Court found that there were actions of Barksdale – false certifications to HUD as to dates and amounts of construction advances – which constituted dishonesty as a matter of law and that as a matter of law there was knowledge of these dishonest acts prior to March 25.

The trial judge took great pains to point out that not all of the actions of Barksdale constituted dishonest acts as a matter of law and then described those where a jury issue would have been made out had they been the only matters relied on by the defense (Appendix A, p. A-21). The jury issues would have been, first whether it was dishonest to certify on a mortgagee certificate executed in favor of HUD at the beginning of a loan that no advance would be made before approval from HUD, when the signatory was aware that advances had been and would be made without such approval; second, whether it was dishonest to sign the certificates submitted on the occasion of each advance similarly providing that no release of funds would be made without approval when such funds were habitually advanced without approval; and, finally, whether the act of making advances in violation of HUD regulations and in spite of at least two prior certfications that they would not be made, was dishonest.

Had the foregoing acts by Barksdale been the only acts proved by INA and Hartford, Judge Chapman undoubtedly would not have disturbed the jury's verdict; however, INA and Hartford further proved that Barksdale knowingly and

intentionally made false certifications to HUD concerning existing facts to cause HUD to issue its final policy of insurance. The insurance was of great importance to CDW and the employee, for without it the loan could not have been closed and marketed.

Judge Chapman held that, as a matter of law, the act of making false certifications as to existing facts was dishonest. (Appendix A, p. A-22). It was said that:

> The evidence clearly showed that this information (discovered March 16 and reported in the March 19 memo) was incorrect because Barksdale had intentionally falsified the figures so that they would conform with those in FHA's file and FHA would, therefore, insure the permanent loan. Barksdale falsified this form despite the warning on the back thereof that knowingly making a false statement to the FHA for the purpose of influencing in any way the action of that administration constituted a criminal act. Thus, in addition to being dishonest, the false certification of this form was criminal. There is no question that Barksdale knew the information was false and that his purpose was to influence the FHA by getting it to endorse the loan.

Appendix A, pp. A-22-23.

As to the second element of the defense, knowledge of the insured prior to March 25, the trial judge again held that some areas, had they stood alone, would have required a jury determination. Specifically, the Court said that just as the question of whether the making of an advance without approval was a dishonest act would have been a jury issue, "(l)ikewise, whether the knowledge of the over advance practice constituted knowledge of dishonesty was also a question of fact." (Appendix A, p. A-24). The Court went on to say that knowledge of actions which themselves must be deemed dishonest as a matter of law constitutes knowledge

of dishonesty as a matter of law. The defense unquestionably established such knowledge in the most highly placed corporate executives, all of whom were uninvolved in the dishonest acts.

On pages A-24 through A-26 (Appendix A), the opinion of the District Court points out instances where the testimony established beyond any doubt that the highest placed executive officers in the insured corporations (NCNB and CDW) realized what had transpired and the nature of it. Under the bonds in question the knowledge of one uninvolved "insured" as defined in the bonds, imputed as it is to the company, is sufficient to preclude coverage from attaching.

Mr. Cashion, to take one example, acknowledged that he knew on March 19 that Barksdale was trying to cover up what he had done so that the FHA would not learn of his advancing before certification. He testified:

> I can't justify it, but I can explain it. The individual doing it was apparently covering up his mistakes in having advanced money beyond the amount of certification.

Appendix A, p. A-26.

As another example, Mr. Reese testified:

> Q. Based on your review of Mr. Shaw's March 19 memorandum and I am referring to the one that first brought to light the question of the over advances and your subsequent discussions with him and the conference which you had on the following day and so forth, you were aware, were you not, that the over advance situation did involve a false certification being made to FHA or HUD, is that correct?
>
> A. Yes.
>
> Q. And you understood also that false certification was made by an officer or employee of C. Douglas Wilson & Company?
>
> A. Yes.

> Q. At that point in time did you know whether that certification was an oral certification, a written certification or whatever?
>
> A. Written.
>
> Q. Again, based on these same meetings, conferences and memoranda, you are aware that a false certification had in fact been made to FHA?
>
> A. Yes.

Appendix A, p. A-26. Yet Petitioner now advances the argument that the same highly placed and experienced banking men who acknowledged all of the elements of dishonesty through their testimony somehow managed to create a jury issue by their denial that they perceived dishonesty prior to March 25.

CONCLUSION

For the foregoing reasons, Respondents, Insurance Company of North America, and Hartford Accident and Indemnity Company, respectfully submit that the Petition for a Writ of Certiorari should be denied.

Respectfully submitted,

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